IT 96-46
Tax Type: INCOME TAX
Issue: Business/Non-Business (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v.	)	**No.**
	)	**FEIN #**
TAXPAYER	)	**TYE 12/31/89-90**
	)	**Charles E. McClellan**
Taxpayer	)	**Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Neil J. O'Brien of Gardere & Wynne, L.L.P., of Dallas, Texas for TAXPAYER Lois R. Solomon, Special Assistant Attorney General of Chicago, Illinois for the Department of Revenue.

Synopsis:

Taxpayer is a corporation with its principal office located in Dallas, Texas. Taxpayer's business is the wholesale direct sale of home decorative accessories. Taxpayer timely filed Illinois Income and Replacement Tax returns for 1989 and 1990 on which it reported interest income as nonbusiness income allocable to Texas. The Department audited taxpayer's returns, determined that the interest income was business income apportionable to Illinois and issued a Notice of Deficiency on which it assessed additional tax, interest and penalty under Section 1005 of the Illinois Income Tax Act. (35 ILCS 5/1005). The recommendation is to sustain, in part, the Department's determination regarding the interest income and to abate the Section 1005 penalty.

Findings of Fact:

1. Taxpayer is a corporation organized under the laws of the State of Texas. (Stip. ¶ 1).

2. Taxpayer's principal office is located in Dallas, Texas. (Stip. ¶ 1).

3. Taxpayer's business is the wholesale direct sale of home decorative accessories. (Stip. ¶ 3, Ex. B).

4. Taxpayer timely filed Illinois Income and Replacement Tax Returns for 1989 and 1990 on a calendar year basis. (Stip. ¶ 3).

5. Taxpayer's working capital requirements are modest because the direct selling industry is based on cash, not credit, sales, low investments in inventory, and little overhead expenditure. (Stip. ¶ 12).

6. Taxpayer's regular practice is to invest earnings that are not needed in the operation of its wholesale business in long term and short term investments. (Stip. ¶ 12).

7. During the audit period, most of taxpayer's short term investments were in municipal bonds and other short term securities pending favorable changes in the long term money markets and taxpayer's review of opportunities presented to all-cash investors in Texas commercial real estate caused by the collapse of real estate prices in Texas in the late 1980's. (Stip. ¶ 13).

8. On its tax returns, taxpayer reported as non-business income allocable to Texas interest income as follows:

	1989	1990
Short term investments	$ 9,838,381.27	$ 13,465,209.59
Inter company interest	170,854.22	128,238.23
Other	622,428.52	1,108.53
Trade notes receivable (Stip. ¶ 6)	829,431.96	919,997.83

9. The Department audited these returns, reclassified this interest income as business income apportionable to Illinois and issued a Notice of Deficiency ("NOD"). (Stip. ¶¶ 2, 6).

10. The parties stipulated that the trade notes receivable interest, the inter company interest and other interest is business income. (Stip. ¶¶ 7, 8, 9, 10; Ex. D).

11. The short term investment interest was earned in five accounts which taxpayer refers to as "general accounts". These are BANK A, BANK B, BANK C, BANK D and BANK E (Stip. ¶¶ 14, 15; Ex. E).

12. The parties stipulated that interest income earned from the BANK E account is not business income.[1] (Stip. ¶ 16).

13. The short term investments include mortgage backed securities, certificates of deposit, commercial paper and municipal bonds. (Stip. ¶ 12, 13).

14. During 1989 and 1990 these accounts (exclusive of the BANK E account) earned interest income of $7,681,334 and $11,017,682, respectively. (Stip. 19)

15. During the audit period the funds from these general accounts, except the BANK E account, were utilized, in part, as a working capital reserve. (Stip. ¶ 15).

16. None of the funds in the general accounts were designated for a particular use, and all of the funds were available for use in the day to day business operations of the taxpayer. (Stip. ¶ 15).

17. The funds in the general accounts have not been used for collateral for any loans. (Stip. ¶ 15).

18. Taxpayer's tax returns were prepared by an independent certified public accountant and tax advisor who had access to all of the company's records and all information relevant to the allocation of interest to Texas. (Stip. ¶ 21; Ex. G).

19. Taxpayer waived its right to an evidentiary hearing. (Stip. ¶ 23).

Conclusions of Law:

[1]. The BANK E account earned $2,157,047 in 1989 and $2,447,527 in 1990.

The issue in this case is whether all or a portion of the interest earned by the taxpayer during the audit period on the accounts identified as BANK A, BANK B, BANK C, and BANK D is business income or non-business income. Taxpayer argues first, that all of the interest income from the general accounts is nonbusiness income. Taxpayer argues that by treating all of the short term investment interest, other than interest earned on the BANK E account, as business income the Department is taxing extraterritorial income in violation of the principles set down by the U.S. Supreme Court in ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982), Container Corp. of America v. Franchise Tax Board, 463 U.S. 77 (1983), Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980), and Allied Signal, Inc. v. Dir. Tax. Div. 504 U.S. 768 (1992). Alternatively, it argues that only a percentage of the income from these accounts should be treated as business income. The percentage it proposes for each year is determined by dividing the largest amount of funds used by the business during any month in the year by the average yearly investment in these accounts.

The terms "business income" and "nonbusiness income" are defined in the statute as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (35 ILCS 5/1501(a)(1).
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> The term "nonbusiness income" means all income other than business income...." (35 ILCS 5/1501(a)(13).

The courts in Illinois have stated that these statutory provisions establish two tests to determine, if the income in question is business income. These tests are referred to as the "transactional" and "functional" tests. If either test is met, the income is business income. The transactional test classifies income as business income if it is derived from a type of business

transaction in which the taxpayer regularly engages. The functional test is whether the property was used in the taxpayer's regular trade or business. Dover Corp. v. Department of Revenue, 271 Ill.App.3d 700. (1st Dist. 1995). These tests must be applied within the constitutional limits propounded in Allied Signal, *supra*, and the cases cited therein. "[T]he taxpayer always has the distinct burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed." Container Corporation of America, *supra*, at 175. "In order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to those carried out in the taxing State. ... Hence, for example, a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." Allied -Signal, Inc., *supra* at 787. That, in essence, is the situation in this case.

Taxpayer regularly invested its excess cash in short term interest bearing accounts which it referred to as its "general accounts". It considered these accounts, in part, as a working capital reserve. There is nothing in the record to indicate what part of these accounts taxpayer considered as working capital during the years at issue. The only allusion to this part is the taxpayer's after-the-fact arbitrary calculation of a portion that it argues might be considered as working capital. Taxpayer has not met its burden of proof that the transactions were not entered into in the regular course of its business or that the funds were not used in the taxpayer's regular trade or business operations as required by the tests set forth in Dover, *supra*. In fact, taxpayer admitted that these funds were used for working capital. Therefore, the short term interest income, except for the interest earned on the BANK E account, is business income apportionable to Illinois.

No penalty should be imposed under § 1005. During the audit period, taxpayer did not prepare its own tax returns. The returns were prepared by an independent certified public accountant and tax advisor who had access to all information relevant to the allocation of interest to Texas and, after examining the issue, prepared the returns allocating interest income to Texas. Taxpayer relied on the advice and assistance of competent professionals. These factors indicate reasonable cause for the underpayment. Accordingly, the § 1005 penalty should not be imposed. See, 86 Admin. Code § 700.400.

WHEREFORE, for the reasons stated above, it is my recommendation that, except for the interest earned on the BANK E account, the Department's determination that the interest income was business income be sustained. It is my further recommendation that the Section 1005 penalty be abated.

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Date

Charles E. McClellan
Administrative Law Judge